

IT 96-8
Tax Type:
Issue:

INCOME TAX
Apportionment: One Factor/Three Factor Application
1005 Penalty (Reasonable Cause Issue)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS,

)

)

Petitioner

v.

TAXPAYER,

Taxpayer

}

No.

}

FEIN:

}

Linda K. Cliffl

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Admin. Law Judge

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RECOMMENDATION FOR DISPOSITION

APPEARANCES: H. Randolph Williams of Baker & McKenzie, for TAXPAYER; John R. Doherty, Staff Attorney, for the Illinois Department of Revenue.

SYNOPSIS:

This case involves TAXPAYER ("TAXPAYER" or "Taxpayer"), a Delaware corporation, authorized to do business in the State of Illinois. On June 15, 1989, the Department of Revenue issued an assessment for income tax against the taxpayer for the year ended 10/31/86 in the amount of \$13,147.10, inclusive of tax, penalty and interest to the date of issuance.

This matter comes on before the Office of Administrative Hearings pursuant to the taxpayer's timely protest of the Notice of Deficiency dated July 31, 1989. At issue are the questions: 1) whether the gross receipts from the licensing of software by taxpayer should be included in the numerator of its Illinois sales factor pursuant to 35 **ILCS** 5/304(a)(3)(C)(ii); 2) if it is determined that inclusion of 100 percent of the gross receipts from the software is required in the numerator of the sales factor, whether taxpayer is entitled to use an alternative method of apportionment as provided under 35 **ILCS** 5/304(f); and 3) if it is determined that the deficiency assessed against the taxpayer is proper, whether the Section 1005 penalty should be abated due to reasonable cause.

A hearing was held and evidence was taken by way of testimony regarding the issues. On consideration of these matters, it is recommended that these issues be resolved in favor of the Department.

FINDINGS OF FACT:

1. Taxpayer develops and produces modified computer software for various business applications. As much as 98.8% of the gross receipts of TAXPAYER are generated from the licensing of the use of such software. The software is installed and modified for the purchaser at the purchaser's site. (Dept. Ex. No. 2).

2. Taxpayer licensed 26 products to customers. Twenty-five products were owned by TAXPAYER and one was licensed from a third party to whom royalties were paid by TAXPAYER. (Tr. pp. 54-56).

3. For the taxable year ending 10/31/86, TAXPAYER filed Illinois income tax returns which reported 100 percent of its property and payroll as being in Illinois, and 4.9335% of its sales as attributable to Illinois based on the situs of the end user of the software. (Tr. p.15; Dept. Ex. No. 2).

4. Taxpayer has a network of "affiliates." (Tr. p. 48). The affiliates solicit potential customers, make sales presentations, and negotiate the terms and conditions of the software license agreement. (Tr. p. 58). Affiliates were responsible for modifying the software to the customer's requirements and installing the software at the customer's site. (Tr. p. 36, 58)

5. Taxpayer has a contractual relationship with the affiliates. (Tr. p. 36). The affiliates were forbidden to handle competing products; most affiliates only handled TAXPAYER products. (Dept. Ex. No. 9).

6. Affiliates did not have the authority to accept contracts and all contracts were forwarded to Chicago for approval. (Tr. p. 67). The contracts for the sale of the software were between the customer and TAXPAYER. The affiliates were not a party to the contract. (Tr. p. 45). The affiliates in the United States prepare all invoices to customers with all remittances being sent by the customer directly to the taxpayer. (Dept. Ex. No. 2).

7. The affiliates were paid a commission by taxpayer for the sales activity and the implementation of the software. The commissions were based on a percentage ranging between 40 and 50 percent of the software license amount. (Tr. pp. 63-64). The customers would contract with and pay the affiliates directly for any modifications to the software and for training. (Tr. p. 64).

8. None of the affiliates are majority-owned by the taxpayer. (Tr. p. 47).

9. Most of the affiliates are corporations, the rest are partnerships. (Tr. p. 66).

10. During the year in question, taxpayer employed four regional managers who had management responsibility for three to five affiliates. (Tr. p. 53). The regional manager would be the liaison between TAXPAYER and the affiliates. The regional manager would take calls from the affiliates when they needed sale strategy assistance, or when the affiliates requested a discount for a customer or when the software had bugs. (Tr. p. 59). The regional manager would occasionally accompany the affiliate on sales calls. In the case of a small affiliate, they could be involved in as many as half the client calls, and in the case of a large affiliate, they would meet with only one client in ten. (Tr. p. 60).

11. Taxpayer also employed affiliate support personnel that would provide product assistance or fill in for one of the affiliate's consultants when they were unavailable due to vacation, illness or a scheduling conflict. (Tr. p. 61).

12. Taxpayer provided sales training and technical training to the affiliates. (Tr. p. 62). Typically the training would occur at the affiliate's site and would involve one or two of taxpayer's personnel for a two or three day period. (Tr. pp. 62-63).

13. 30% of TAXPAYER employees spend more than 50% of their time outside Illinois for these purposes. (Dept. Ex. No. 2).

14. Taxpayer did not file any state income tax or payroll tax returns for any state other than Illinois for the year in question. In subsequent years returns were filed in Connecticut and New York after state audits. (Tr. pp. 32-33).

15. Expenses of the taxpayer for the year ended 10/31/86:

Commissions to Affiliates	\$7,112,728
Research & Development	\$1,516,710
Sales and Marketing	\$2,375,654
Royalties	\$ 427,755
General & Administrative	\$1,513,546

(Dept. Ex. No. 9). The research and development expenses were performed approximately 50% in Illinois, with the rest being performed overseas. (Dept. Ex. No. 9). The amount designated as sales and marketing was for commissions paid by TAXPAYER to its regional managers, for their travel expenses, and for advertising and other expenses of the marketing department of TAXPAYER. (Tr. p. 49). The amount designated royalties is for the one product which was not owned by TAXPAYER. (Tr. p. 49). General and administrative expenses were primarily incurred in Illinois. (Dept. Ex. No. 9).

CONCLUSIONS OF LAW:

ISSUE #1

I find that 100% of the gross receipts of the taxpayer arising from the licensing of software is attributable to the State of Illinois.

The taxpayer in this case engages in the business of licensing customized software which is intangible personal property. Section 304(a)(3)(C) of the Illinois Income Tax Act (35 ILCS 5/304(a)(3)(C)) states how the sales factor for the sale or license of intangible personal property shall be computed:

Sales, other than sales of tangible personal property, are in this State if:

- i) the income-producing activity is performed in this State; or
- ii) the income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on costs of performance.

"Income-producing activity" is defined by Department Regulation:

The term 'income producing activity' applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor...Accordingly, the income producing activity includes but is not limited to the following:

- i). The rendering of personal services by employees or the utilization of tangible and intangible property by the person in performing a service.
- ii) The sale, rental, leasing, licensing or other use of real property.
- iii) The rental, leasing, licensing or other use of tangible personal property.
- iv) The sale, licensing or other use of intangible personal property. (emphasis added)

86 Admin. Code, ch. I, Sec. 100.3370(c)(3)(A)¹.

Sales of intangible property are sourced to the State of Illinois if either all of the income-producing activity of the taxpayer occurs within the State, or if the income producing activity occurs both within and without the State, a greater proportion of that activity occurs within Illinois.

First, a determination must be made as to what the income-producing activities of the taxpayer are. Taxpayer has given testimony regarding the activities of its affiliates in marketing its product, and the activities of its own employees with regard to sales support. Research and development, which is

¹ Formerly 86 Admin. Code Sec. 100.3650(c)(3)(A).

mentioned in taxpayer's Statement of Objections, is also a part of the income-producing activity associated with the licensing of software. There may be other activities which would be included in the term "income-producing activities" which are included in general and administrative expenses on which the record is silent.

Looking only to the sales activity of taxpayer, TAXPAYER's regional managers were involved in making sales calls and providing support to the affiliates both within and without the State. TAXPAYER also employed affiliate support personnel who would fill in for the affiliates when they were unavailable due to vacation, illness or scheduling conflicts. Thirty percent of TAXPAYER's employees spent 50% of their time outside the State. The majority of the sales activity, however, was performed by the affiliates. They were responsible for identifying potential customers, making sales presentations, negotiating the software licensing agreement and installing the software at the customer's site.

Taxpayer argues that a greater proportion of the income-producing activity occurred outside of Illinois based on costs of performance. Since more than one-half of taxpayer's costs associated with licensing software are for commissions paid to affiliates, the threshold question must be whether the activities of the affiliates should be considered.

Each of the affiliates is a separate legal entity, either a corporation or a partnership. The affiliates are not owned by taxpayer, nor is there is a unitary relationship between TAXPAYER and its affiliates. The affiliates also do not have the authority to accept contracts. The affiliates may write up contracts, but they must have approval for any changes made to the basic form. All contracts are forwarded to Chicago for approval, and payment is made by the customers directly to Chicago. After the software is installed the affiliates have the ability to contract directly with customers for modifications that are necessary to be made to the software and for any training that is provided. Furthermore, no payroll tax returns were filed by the taxpayer on behalf of the affiliates, so they apparently were not considered to be employees by the taxpayer. In fact, taxpayer filed no payroll tax returns in any state other than Illinois.

I find that the affiliates are third parties that are sufficiently independent that their activities should not be attributed to TAXPAYER. These activities come within the language of Regulation Section

100.3370(c)(3)(A)² as "activities performed on behalf of a person." The activities of the affiliates, therefore, cannot be included when determining what income-producing activities are performed within or without the State.

It should be noted that "income-producing activities" are not to be determined by reference to generally-accepted accounting principles ("GAAP"), as taxpayer maintains. It is the costs of performance that are to be determined by GAAP. According to Department Regulation, "Costs of performance" is defined as "direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person." 86 Admin. Code, ch. I, Sec. 100.3370(c)(3)(B).³

According to taxpayer's records, only 30% of TAXPAYER's employees spent more than 50% of their time outside Illinois, which would equate to 15% of the sales and marketing expense. In addition 50% of the research and development expense occurred outside Illinois. Without more evidence in the record that other income-producing activities occur outside of Illinois, the taxpayer has failed to rebut the Department's position that the greater proportion of income-producing activity is performed inside the State.

Based on the evidence presented, I find that the majority of taxpayer's income-producing activity takes place within the State of Illinois, and therefore the receipts from the licensing and sale of software should be included in the numerator of the sales factor for the State of Illinois.

ISSUE #2

Taxpayer has requested the Director's permission to use an alternative method to apportion income pursuant to 35 ILCS 5/304(f). Section 304(f) provides that if the allocation and apportionment provisions of IITA Section 304(a) through (e) do not fairly represent the person's business activity in the State, the person may petition the Director to employ an alternative method to apportion income. The

² 86 Admin. Code Sec. 100.3370(c)(3)(A), formerly, 86 Admin. Code Sec. 100.3650(c)(3)(A).

³ Formerly 86 Admin. Code Sec. 100.3650(c)(3)(B).

regulation at 86 Admin. Code, ch. I, Sec. 100.3390(c) states "The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State."

Taxpayer has failed to produce any evidence which would show that the current apportionment methodology is out of all proportion to the business activity in the State. Taxpayer's headquarters are in Illinois, and it has no property or payroll in any other state. Sales efforts of the affiliates are managed by the regional managers who are employed in Illinois. In fact, taxpayer's position was that its contacts with other states were so minimal that no other tax returns were required or filed for the year at issue.

Taxpayer has argued that its method of apportionment produces the result that would have obtained if tangible rather than intangible personal property had been licensed, and that this result fairly reflects the business activity of the taxpayer in Illinois. Taxpayer is unable to sustain this argument in light of the "throwback rule." Section 304(a)(3)(B)(ii) of the IITA (35 **ILCS** 5/304(a)(3)(B)(ii)) provides that sales of tangible personal property are in this State if the property is shipped from Illinois to a state where the seller is not taxable. Taxpayer has licensed its intangible personal property throughout the United States, but did not file income tax returns or pay taxes to any other states for the year in question. If tangible personal property were involved, all of taxpayer's sales would be "thrown back" to Illinois since the taxpayer had not paid tax to any other state. Dover Corporation v. Department of Revenue, 271 Ill.App. 3d 700, 648 N.E.2d 1089 (1st Dist. 1995).

Taxpayer's request to use an alternative method of apportionment, therefore, is denied.

ISSUE #3

Regarding the imposition of the Section 1005 penalty, I find that taxpayer has not met its burden of proof in establishing reasonable cause. Taxpayer apportioned less than 5% of its sales to Illinois, and filed no other state income tax returns during the year in question. It is not reasonable to argue both that only a small percentage of taxpayer's gross receipts are sufficiently connected to the State of

Illinois to be subject to tax while taxpayer is not filing income tax returns or paying income tax in any other state. The Section 1005 penalty, therefore, will stand.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized in its entirety.

Date:

Linda K. Clifffel
Administrative Law Judge